



## A MESSAGE FROM THE SECRETARY OF THE TREASURY

I am pleased to present the fiscal year 2004 Financial Report of the United States Government, reflecting the Treasury Department's long-standing responsibility and commitment to report on the Nation's finances. Our objective in preparing these consolidated financial statements is to provide the Congress and the public with a reliable, timely and useful report on the cost of the Government's operations, the sources used to fund them, and the implications of the Government's financial commitments.

In fiscal year 2004, government revenues were \$1.9 trillion, an increase of more than \$100 billion over fiscal year 2003 and the first increase in revenues in four years. The net cost of the government's operations was \$2.5 trillion, including all accrued costs. Total revenues less operating costs resulted in a net operating cost of slightly more than \$615 billion, down from \$668 billion last year. The budget deficit for 2004 was \$412 billion. The primary component of the difference between the budget deficit and the net operating cost was actuarial expenses associated with post-retirement health care and pensions, and veterans' compensation.

Since Treasury issued the first audited government-wide report for fiscal year 1997, we have made great strides in accelerating the timeliness of government financial reporting and improving its reliability. By accelerating the issuance of this year's report to December 15, just 75 days after the end of the fiscal year, we have made much progress towards matching the timeliness of private sector financial reporting. This acceleration is notable this year because 22 of the 24 major departments and agencies completed their audited financial statements by November 15, within 45 days of the end of the fiscal year. In addition, Treasury has just implemented a new reporting system, which compiles information from agency financial statements and is designed to ensure consistency in reporting and compliance with generally accepted accounting principles.

These are important milestones in Federal financial reporting, and I am pleased with the progress we have made this year. At the same time, I recognize that we will not benefit from the Report's full value in informing the public and supporting critical decision making until our reporting credibility is unquestioned. As we look toward our nation's financial future, Treasury is dedicated to achieving this credibility.



John W. Snow

# MANAGEMENT'S DISCUSSION AND ANALYSIS

## Introduction

The accompanying *2004 Financial Report of the United States Government (Financial Report)* is prepared to give the President, Congress, and the American people information about the financial results and position of the Federal Government. It provides, on an accrual basis of accounting as prescribed by U. S. generally accepted accounting principles (GAAP), a broad, comprehensive view of the Federal Government's finances. This report states the Government's financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. Finally, it discusses important financial issues and significant conditions that may affect future operations.

The *Financial Report* required by 31 U.S.C. § 331(e)(1) is to be submitted to Congress by March 31 and is subject to audit by the Government Accountability Office (GAO). It consists of Management's Discussion and Analysis (MD&A, not subject to audit), Statements of Net Cost, Statements of Operations and Changes in Net Position, Reconciliations of Net Operating Cost and Unified Budget Deficit, Statements of Changes in Cash Balance from Unified Budget and Other Activities, Balance Sheets, Stewardship Information (not subject to audit), Notes to the Financial Statements, and Supplemental Information (not subject to audit). Each section is preceded by a description of its contents.

## Executive Summary

### Accelerated Reporting Results

A record 22 of the 24 major Federal agencies issued their financial reports within 45 days after the end of fiscal year 2004. This marks a significant milestone in federal financial reporting since just a few years ago Federal agencies took 5 months or more to produce this information. The Office of Management and Budget (OMB) set a deadline for agencies to complete Performance and Accountability Reports, including audited financial statements, by 45 days from the end of the fiscal year. The new deadline emphasizes the need for timely and accurate financial information for decision-making.

The accelerated reporting of agency financial statements provided the foundation for the earlier issuance of this report. For the first time since the report was issued in 1998, the *Financial Report's* issuance was accelerated to December 15th. This year's improvement in timeliness was concurrent with the efforts across Government to implement new financial management disciplines, processes, and systems to produce more timely and accurate information. This year's more timely reporting is the end result of multiple years of planning and executing across Government. Federal agencies will continue to build upon this year's accomplishments to meet the overall objective of using timely and accurate financial information to make program management decisions.

### Financial Results

Each year the Administration issues two reports that detail financial results; one on the budget basis and this one on the accrual basis. The two reports complement each other. The budget report contains receipt and outlay information primarily on the cash basis and compares the results to the appropriations for the year. The *Financial Report* uses those transactions as its base and also contains non-cash based revenues and expenses. For example, these revenues produce accounts receivable balances and the expenses produce liabilities for items such as pensions, accounts payable, and environmental clean up costs. Net operating cost was \$615.6 billion in fiscal year 2004, a decrease of \$52 billion from \$667.6 billion in fiscal year 2003. This decrease resulted from an increase in revenues of \$116.7 billion which was somewhat offset by an increase in net operating cost of \$64.7 billion. The increase in net cost was caused by an increase in budgetary outlays reduced by a reduction of \$108.5 billion in actuarial costs.

## **Liabilities and Additional Responsibilities**

The 2004 balance sheet shows assets of \$1,397 billion and liabilities of \$9,107 billion, for a negative net position of \$7,710 billion. In addition, the Government's responsibilities to make future payments for social insurance and certain other programs are not shown as liabilities according to Federal accounting standards; however, they are measured in other contexts. These programmatic commitments remain Federal responsibilities and as currently structured will have a significant claim on budgetary resources in the future.

In a table on page 11 of this section, the net present value for all of the responsibilities (for current participants over a 75-year period) is \$45,892 billion, including Medicare and Social Security payments, pensions and benefits for Federal employees and veterans, and other financial responsibilities. The reader needs to understand these responsibilities to get a more complete understanding of the Government's finances.

Included in the table this year is the impact of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Medicare Prescription Drug Plan) that was enacted on December 8, 2003. Read more about the impact and growth of these programs in the MD&A's Additional Responsibilities section starting on page 10.

## **Economic and Budgetary Results**

The economy strengthened in fiscal year 2004, with real gross domestic product (GDP) growing at a faster pace than in the prior fiscal year and employment posting a large increase after declining in each of the previous 3 fiscal years. Rising employment and income contributed to an increase in budget receipts in fiscal year 2004, the first gain in 4 years. Outlays, however, rose more than receipts and the Federal budget deficit widened in fiscal year 2004 to \$412.3 billion, an increase of \$37.5 billion from \$374.8 billion in fiscal year 2003. This increase resulted from an increase in outlays of \$135.2 billion that was offset by an increase in receipts of \$97.7 billion. The increase in outlays was mainly due to increases of about \$50 billion, \$40 billion, and \$22 billion at the Department of Defense (DOD), the Department of Health and Human Services (HHS), and the Social Security Administration (SSA), respectively.

Overall results in fiscal year 2004 were mixed. The final results show a reduction of the accrual-based net operating cost versus an increase in the budget deficit. This \$89.5 billion closing of the gap between the two results is almost entirely due to a \$108.5 billion reduction in the rate of increase in accrual-based cost for pension, health care, and disability liabilities for civilian and military personnel, and veterans.

## **Significant Reporting Items for Fiscal Year 2004**

### **Medicare Prescription Drug Plan**

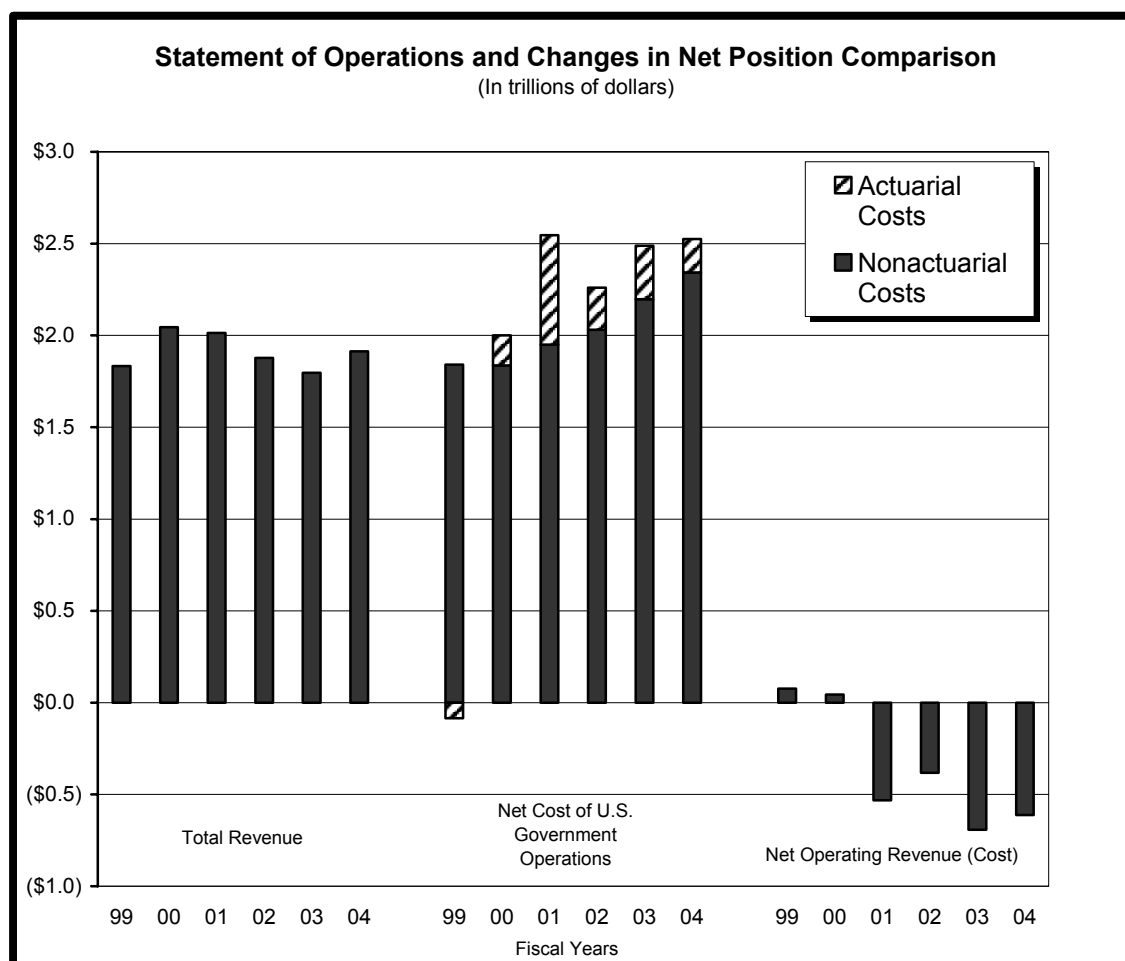
The Medicare Prescription Drug Plan provides discounts on prescription drugs for Medicare beneficiaries in 2004 and 2005 and, beginning in 2006, allows them to enroll in a stand-alone drug plan or private health plan. The 2004 Medicare Trustees' Report estimates that the 75-year period net present value of expenditures less premium income for the Prescription Drug Plan is \$8,119 billion for all current and future participants (i.e., open group); the amount is \$6,306 billion for all current participants (i.e., closed group). See page 8 to read more about the Medicare Prescription Drug Plan.

### **Debt Ceiling**

At the end of fiscal year 2004, the outstanding debt subject to limit approached the \$7,384 billion statutory limit. Subsequent to the end of the fiscal year, on October 14, 2004, Treasury began taking steps to avoid surpassing the debt ceiling. On November 19, 2004, legislation became effective raising the statutory debt limit by \$800 billion to \$8,184 billion (P.L. 108-415).

## Financial Results

### Revenue and Cost Summary



### Accrual-Based Results

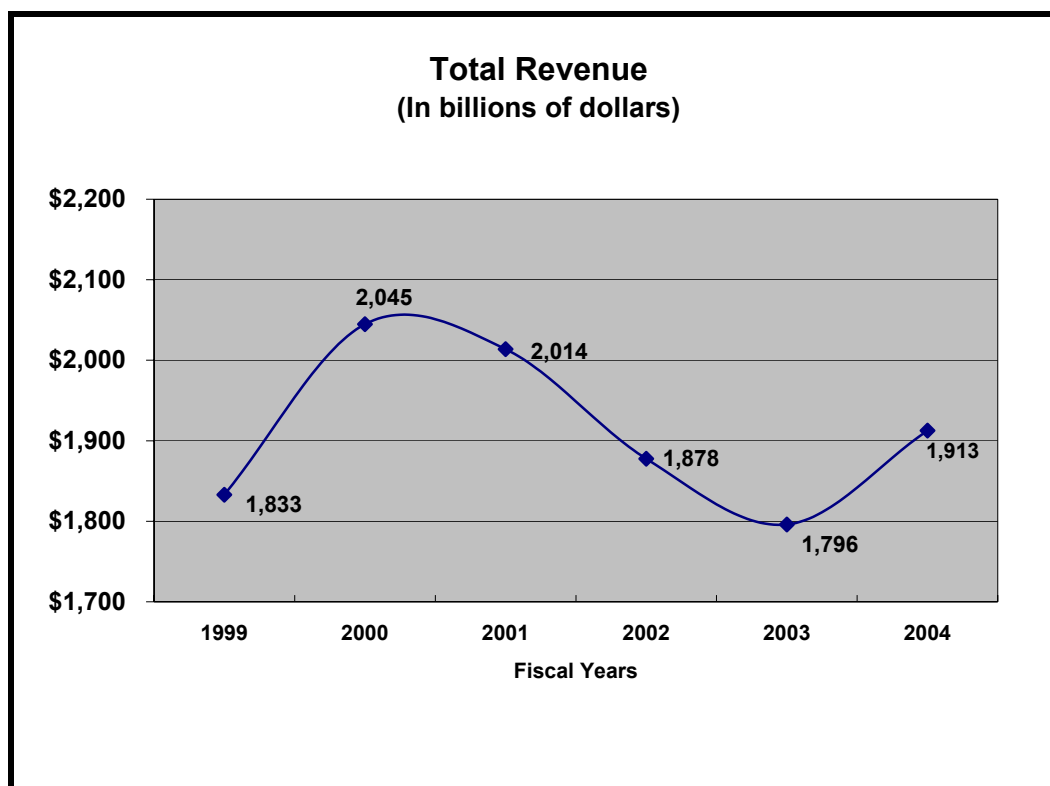
The financial statements (pages 60-64) present information about the financial position of the Federal Government, the net costs of its operations, and the financing sources used to fund its operations. The information in these statements gives a comprehensive view of the Government's finances. The information is reported generally on the accrual basis of accounting in which costs are recorded when a liability is incurred. This differs from the primarily cash basis used in calculating the budget results, in which outlays are recorded when bills are actually paid. See Note 1B (Basis of Accounting and Revenue Recognition) of this *Financial Report* for a discussion of how revenues are recorded.

The net operating cost as shown in these financial statements for fiscal year 2004 was \$615.6 billion, compared to a budget deficit of \$412.3 billion. This resulted in a \$203.3 billion difference between the reported net operating cost and the budget deficit. The primary component of the difference between the budget deficit and accrual reported results is the recognition of the year's actuarial expense for pension and health liabilities for civilian and military employees and veteran's compensation of \$182.1 billion. Also see a comparison of net operating cost as reported versus net operating cost excluding the change in these actuarial liabilities on page 8. These same programs

were also responsible for the greater \$292.8 billion difference in fiscal year 2003 which had a net operating cost of \$667.6 billion and a budget deficit of \$374.8 billion.

For fiscal year 2004, the \$89.5 billion difference between the lower 2004 \$203.3 billion and the higher 2003 \$292.8 billion differences between net operating cost and the budget deficit was due to three major items: increased revenues, decreased actuarial costs, and higher outlays, primarily at DOD, HHS, and SSA. For a detailed reconciliation between the two numbers, see the Reconciliations of Net Operating Cost and Unified Budget Deficit in the Financial Statements section.

Because the Government traditionally has been viewed from a budget perspective, and because many of the terms used to describe financial events have different meanings when describing budget outcomes, a conscious effort has been made to refer to budget-based amounts by using the term “budget” in order to eliminate any possible confusion. Net operating revenue (cost) is the term used to represent accrual-based operating results and equates to revenue less net cost of Government operations.

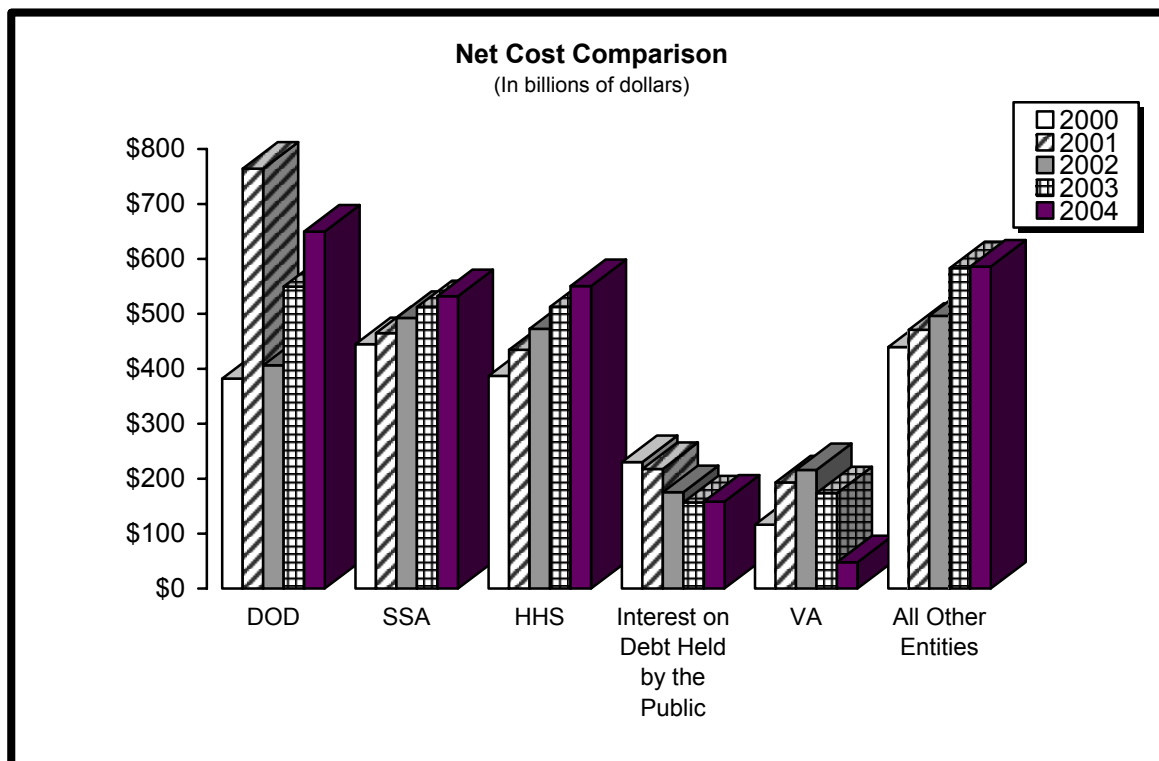


As shown in the chart above, fiscal year 2004's total revenue was \$1,912.7 billion. This amount compares to \$1,796 billion in 2003, an increase of \$116.7 billion (or 6.5 percent). Revenue has increased in all tax categories mainly due to the addition of over 2 million new jobs to the economy (with a slight decline in the unemployment rate) and higher corporate profits.

The Government's main source of revenue comes from its ability to demand payments from the public (e.g., taxes, duties, fines, and penalties). The Government's principal source of revenue is individual income and withholding taxes. In 2004, this revenue category was \$1,512.3 billion, representing 79.1 percent of total revenue, and a 2.1 percent increase from 2003. There was an increase of 43.4 percent in corporate income taxes in 2004; corporate income tax revenue was \$183.8 billion, or 9.6 percent of total revenue. Corporate income taxes have not been this large since 1999.

In addition to revenue from its ability to tax, the Government's other source of revenue comes from providing goods and services to the public for a fee. This type of revenue is called “earned” revenue because it results from the exchange of transactions. Examples of earned revenue include the postage and mailing fees paid to the U.S. Postal Service and Medicare Part B premiums collected by HHS (these premiums only comprise part of Medicare Part B's funding). This revenue is used to pay for or *offset* the costs of administering these programs or services and is included in the calculation of net cost on the Statements of Net Cost. In fiscal year 2004, the Government earned

\$207.1 billion from this type of revenue. This compares to \$164.8 billion earned in fiscal year 2003 for an increase of \$42.3 billion (or 25.7 percent). In 2003, the increase from 2002 was \$8.2 billion (or 5.2 percent).



The chart above compares major elements of net cost by fiscal year. The largest change in net cost was at the Department of Veterans Affairs (VA), which decreased by \$125.7 billion (or 72.4 percent). The calculation of an actuarial liability can cause an agency's total net cost to vary widely from year to year, and that was the case with VA in 2004. The calculation of the actuarial liability for future years' veterans' compensation decreased by \$30 billion in 2004 and increased by \$105.6 billion in 2003.

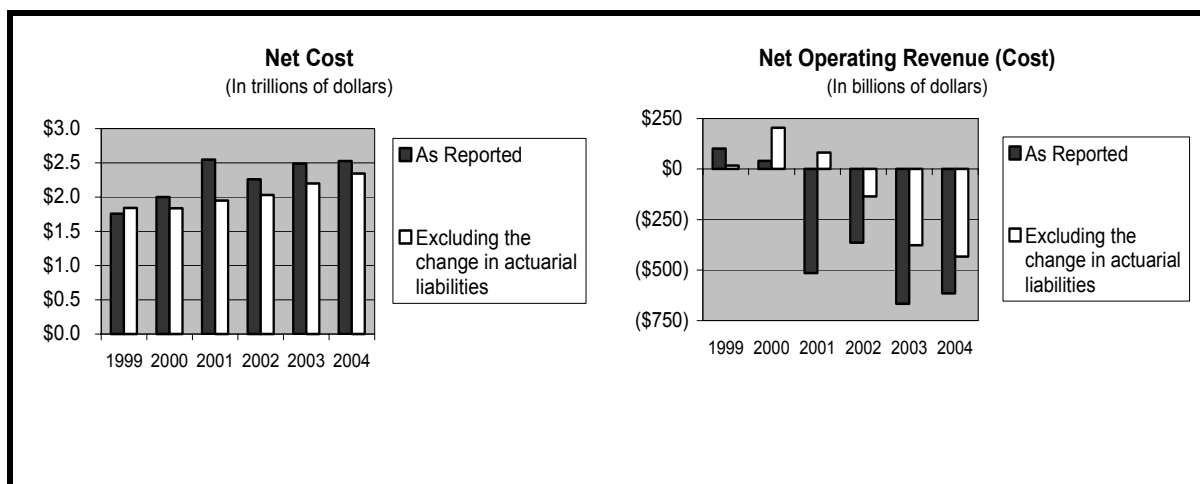
DOD had the highest agency net cost in 2004 and 2003—\$649.8 billion, (18.2 percent) and \$549.7 billion, respectively. The majority of this \$100.1 billion increase was due to the \$91.1 billion increase in the Military Retirement Fund's actuarial liability. The actuarial liability increased due to a new law (discussed further in the Liabilities section of the MD&A) which allows for increased benefits to disabled military retirees.

The Army General Fund increased by \$24.1 billion as a result of the Presidential approval of the Emergency Wartime Supplemental Appropriations Act (P.L. 108-11). Congressional funding for the global war on terror was received through appropriated and supplemental funding in fiscal year 2004. The increase supports the incremental costs of Reserve forces on active duty in a war zone versus peacetime training. In addition, the military pay appropriations received a 3.7 percent pay increase for all soldiers and a pay raise of up to 6.25 percent for selected military pay grades. Moreover, the Navy General Fund increased by \$15.7 billion due to an increase in depreciation costs from recording Military Equipment in fiscal year 2003 and continuing into fiscal year 2004. The Navy's depreciation costs also increased for buildings, structures, and utilities. These increases resulted from a change in the depreciation model that was used.

The social insurance costs at HHS and SSA continued their upward trend during 2004. From 2003 to 2004, the consolidated net costs of HHS and SSA increased by 7.4 and 3.9 percent, respectively. These increased net costs were due mainly to benefit payment increases of 9 and 3 percent at HHS and SSA, respectively. SSA also experienced a 1 percent increase in the number of its Old-Age, Survivors, and Disability Insurance program beneficiaries. To read more about the social insurance programs managed by these agencies, see the MD&A's Additional Responsibilities section and the *Financial Report's* Statements of Social Insurance in the Stewardship Information section.

The interest on debt held by the public increased slightly from \$156.8 billion in fiscal year 2003 to \$158.3 billion for fiscal year 2004. Along with the increase in debt principal, the interest on the debt increased slightly by

\$1.5 billion (or 1 percent). Even though the principal on the debt increased due to the increased borrowing from the public, the interest on the debt held by the public rose only slightly because maturing, longer-dated, high-coupon debt was replaced by lower-coupon debt.



The charts above show that over the past 6 fiscal years, significant costs associated with certain employee benefit liabilities have had a major and variable impact on the Government's cost of operations. These incremental costs are the result of changes in interest rates and other actuarial assumptions. Also shown is that, all other costs are steadily trending upward and the net operating revenue (cost) has fluctuated from almost break-even in fiscal year 1999 to a net operating cost of \$615.6 billion versus \$433.5 billion in fiscal year 2004, excluding these adjustments. Actuarial liabilities include Federal employee and veteran benefits payable and are discussed in Note 11 of the Notes to the Financial Statements section.

### Medicare Prescription Drug Plan

The Medicare Prescription Drug Plan, enacted on December 8, 2003, provides discounts on prescription drugs for Medicare beneficiaries in 2004 and 2005 and, beginning in 2006, allows them to enroll in a stand-alone drug plan or private health plan.

The Discount Card & Transitional Assistance Program was enacted as part of the Medicare Prescription Drug Plan. This program is voluntary and provides relief to people with Medicare to help reduce their costs for prescriptions before the new drug benefit is implemented on January 1, 2006. The two parts of this program are: (1) The Prescription Drug Discount Card Program that enables Medicare beneficiaries to obtain 10 to 25 percent discounts on prescription drugs, and (2) The Transitional Assistance Program where Medicare provides a \$600 credit for the purchase of prescription drugs in 2004 and up to an additional \$600 credit in 2005 to people with incomes that are not more than 135 percent of the poverty line if they do not have certain other drug coverage.

For fiscal year 2004, the Centers for Medicare & Medicaid Services (CMS) estimated that 7.3 million people were expected to enroll in the Prescription Drug Discount Card Program, and 4.7 million of these people were also expected to enroll in the Transitional Assistance Program. For fiscal year 2004, CMS estimated that the Discount Card & Transitional Assistance Program would cost the Government \$2.3 billion, but the actual cost was \$216 million. The 2004 Medicare Trustees' Report estimates that the 75-year period net present value of expenditures less premium income for the Prescription Drug Plan is \$8,119 billion for all current and future participants (i.e., open group); for current participants (i.e., closed group), the estimated net present value is \$6,306 billion.

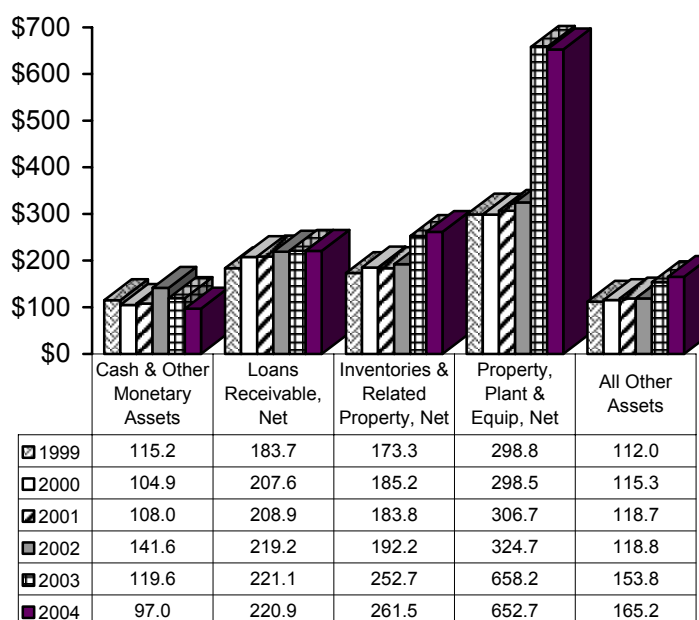
## Asset and Liability Summary

### Assets

The accompanying chart depicts a 6-year comparison of the major categories of reported assets as of September 30, for fiscal years 1999 through 2004.

### Assets - Key Items Comparison

(In billions of dollars)



Total assets decreased slightly from \$1,405.4 billion to \$1,397.3 billion (0.6 percent). A \$22.6 billion decrease in cash was counterbalanced by a decrease in liabilities for debt held by the public. Prior to 2004, the Government maintained formal arrangements with numerous financial institutions for holding time deposits known as “compensating balances.” With the passage of the Consolidated Appropriation Act of 2004, Treasury received a permanent and indefinite appropriation to compensate banks for services rendered. Therefore, compensating balances were closed, resulting in a decrease in cash.

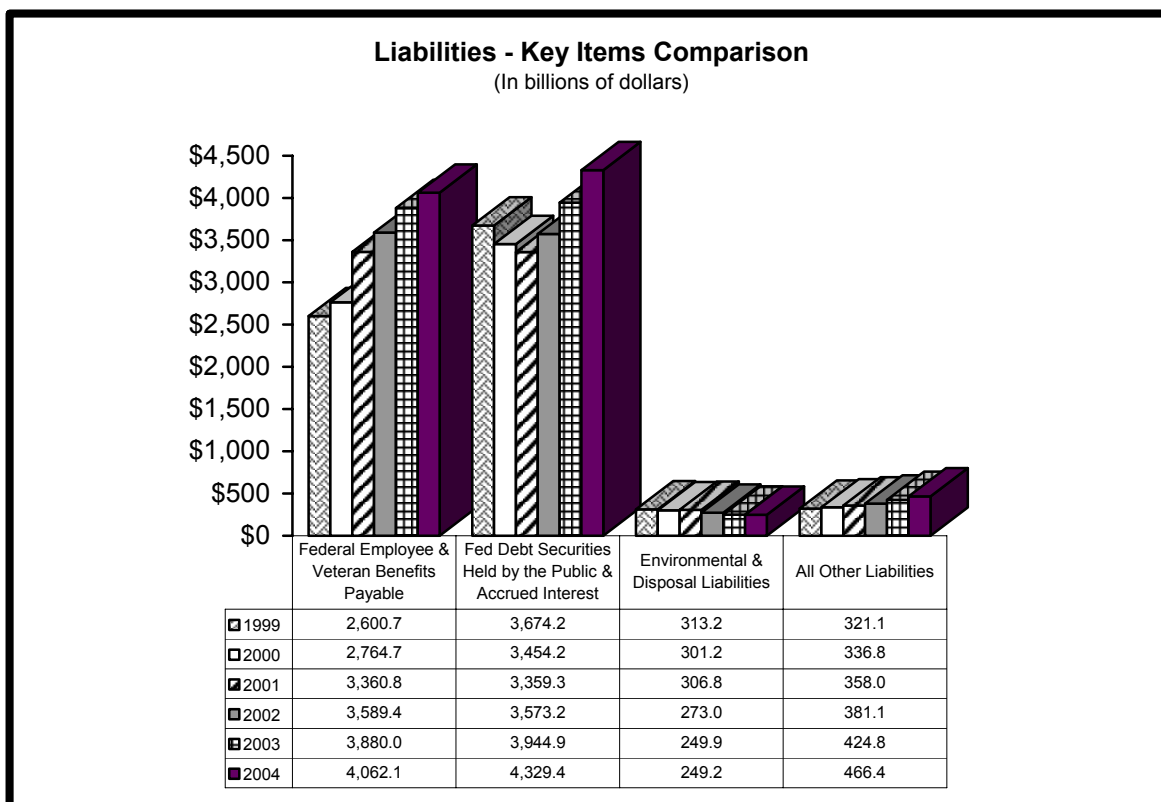
The U.S. Government’s largest asset (46.7 percent of total assets) remains net property, plant, and equipment. A change in Federal accounting standards, effective in fiscal year 2003, resulted in a net book value of \$325.1 billion in military equipment at DOD being presented on the balance sheet for the first time.

Inventories and related property, net, is the next largest asset at almost 18.7 percent of total assets and increased by \$8.8 billion or 3.5 percent in 2004. DOD holds 81.5 percent of the Government’s inventory. Both inventory and operating materials and supplies (a subcomponent of inventory, see Note 6) increased at DOD in 2004, primarily due to the global war on terror and the Air Force’s change in the method it uses to value inventory, which included correcting prior years’ valuation errors.

### Liabilities

The following chart presents a 6-year comparison of the major components of liabilities reported on the balance sheets as of September 30, for fiscal years 1999 through 2004. At the end of fiscal year 2004, the U.S. Government’s liabilities increased 7.1 percent from \$8,499.6 billion to \$9,107.1 billion.





Federal debt securities held by the public and accrued interest was again the largest liability at \$4,329.4 billion, 47.5 percent of total liabilities. This is a \$384.5 billion, or 9.7 percent, increase over the balance at the end of fiscal year 2003. The increase in debt held by the public for the last 3 years primarily is due to total Federal spending exceeding total Federal revenues on a cash basis.

Federal employee and veteran benefits payable (44.6 percent of total liabilities) continued a 5-year trend of increases, although the 4.7 percent increase in 2004 was lower than in any of the previous 5 years. Federal employee and veteran benefits payable consists of pension, disability, and retiree health care costs for Federal civilian and military employees, as well as for veterans. In Note 11, this liability is broken down into components for pensions, retiree health care, and veterans.

There was a 13.4 percent increase in military pensions in 2004 due to the National Defense Authorization Act for fiscal year 2004. This new law allows certain disabled military retirees to concurrently receive disability payments from the VA and their DOD military retirement pay. Prior to this legislation, disability payments offset military retirement payments by an equal amount. However, civilian pensions did not rise as much as in previous years due to the effects of an actuarial gain at the Office of Personnel Management (OPM) in 2004.

Retiree health care is larger than veteran benefits for the first time since 2001. Both civilian and military retiree health care rose again this year (8.9 and 6.2 percent, respectively), but at a lesser percentage than last year (10.4 and 15.4 percent, respectively). There was a smaller actuarial loss at OPM in 2004 than in 2003, which lowered the expense portion that figures into the calculation of the liability. At DOD, there were actuarial gains in the largest part (for Medicare eligible retirees) of the health liability, which held down the rate of increase in the liability.

The liability for veteran benefits actually decreased in 2004 by 3.1 percent. The decrease was due to a refinement in the experience assumptions used at the VA to estimate the liability for compensation for male veteran beneficiaries.

## Additional Responsibilities

Historically, the Government's financial situation has been evaluated primarily from a cash-based budgeting perspective that measures the flow of funds in and out of Government accounts. The accrual amounts in this report are an attempt to add currently incurred costs that are unpaid at yearend. In addition, there are several major

programs that, when examined from an accrual perspective, also generate unpaid amounts. This perspective is meant to complement the cash-based budget estimates of future spending and receipts.

In addition to accrual-based results, the overall perspective depicted below includes many responsibilities disclosed throughout this report but not captured by accrual-based operating results or liability balances. An attempt is made here to go beyond the balance sheet to also examine the impact of these other responsibilities.

## Overall Perspective

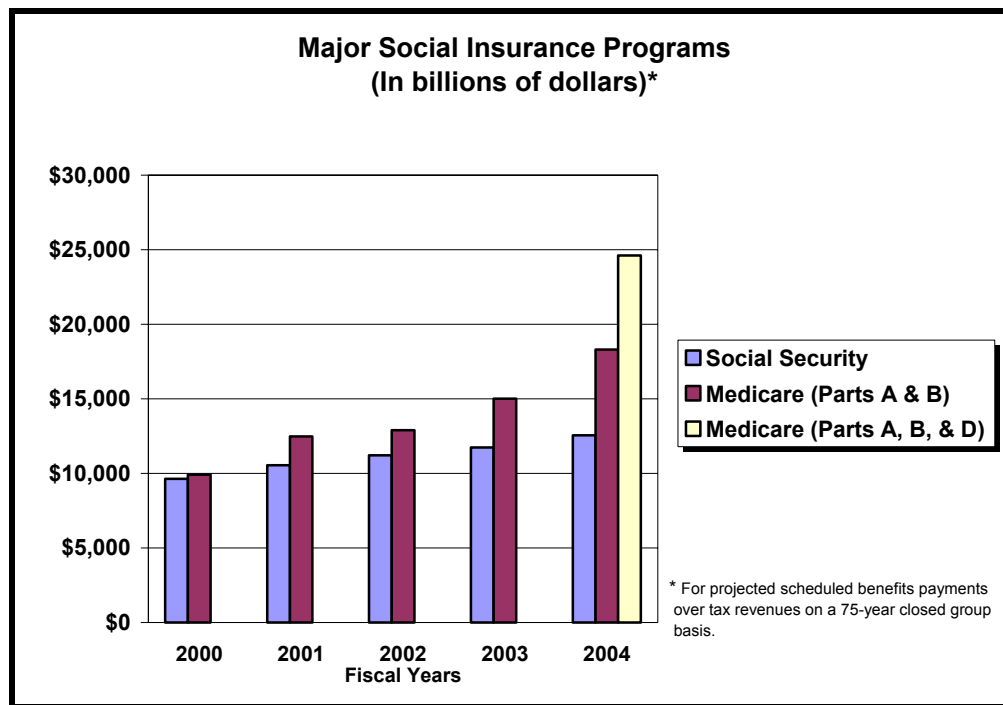
The schedule below reveals a more complete picture of the Government's financial responsibilities—its liabilities and responsibilities on the balance sheet as well as its responsibilities that are tracked off the balance sheet.

Overall Perspective (in billions of dollars)							
	2004			2003			
	Balance Sheet	Additional Responsibilities	Combined Amounts	Balance Sheet	Additional Responsibilities	Combined Amounts	\$ Change
<b>ASSETS</b>							
Inventory, cash	\$ 359	\$ -	\$ 359	\$ 372	\$ -	\$ 372	\$ (14)
Property, plant & equipment	653	-	653	658	-	658	(6)
Loans receivable	221	-	221	221	-	221	(0)
Other	165	-	165	154	-	154	11
<b>Total Assets</b>	<b>\$ 1,397</b>	<b>\$ -</b>	<b>\$ 1,397</b>	<b>\$ 1,405</b>	<b>\$ -</b>	<b>\$ 1,405</b>	<b>\$ (8)</b>
<b>LIABILITIES &amp; NET RESPONSIBILITIES</b>							
Social Insurance							
Medicare (Parts A, B, & D) <sup>1</sup>	-	(24,615)	(24,615)	-	(15,006)	(15,006)	(9,609)
Social Security (OASDI)	-	(12,552)	(12,552)	-	(11,742)	(11,742)	(810)
Other (Railroad Retirement)	-	(112)	(112)	-	(110)	(110)	(2)
Subtotal, Social Insurance	-	(37,279)	(37,279)	-	(26,858)	(26,858)	(10,421)
Fed. empl. & veterans pensions/benefits	(4,062)	-	(4,062)	(3,880)	-	(3,880)	(182)
Federal debt held by the public	(4,329)	-	(4,329)	(3,945)	-	(3,945)	(385)
Other liabilities	(716)	-	(716)	(675)	-	(675)	(41)
Other responsibilities	-	(903)	(903)	-	(862)	(862)	(41)
<b>Total Liabilities &amp; Net Responsibilities</b>	<b>\$ (9,107)</b>	<b>\$ (38,182)</b>	<b>\$ (47,289)</b>	<b>\$ (8,500)</b>	<b>\$ (27,720)</b>	<b>\$ (36,220)</b>	<b>\$ (11,070)</b>
<b>BALANCE (Total Assets minus Total Liabilities &amp; Net Responsibilities)</b>	<b>(\$7,710)</b>	<b>(\$38,182)</b>	<b>(\$45,892)</b>	<b>(\$7,094)</b>	<b>(\$27,720)</b>	<b>(\$34,814)</b>	<b>(\$11,078)</b>
<sup>1</sup> Part D's Medicare Prescription Drug & Transitional Assistance Accounts not included in 2003 because both established after fiscal year 2003. Note: Details may not add to totals due to rounding.							

## Social Insurance Calculations

The social insurance projections in the table above are based on a 75-year period and include expenditures for scheduled future benefits over scheduled revenue for current participants, including those who have reached the eligibility age (closed group). Therefore, as depicted here, the present value for Medicare and Social Security (at January 1, 2004) is \$24,615 billion and \$12,552 billion, respectively. Including the \$903 billion for Other responsibilities that consist of commitments and contingencies such as the Pension Benefit Guaranty Corporation insurance contingency and agency commitments for leases and undelivered orders, and \$112 billion for Railroad Retirement, the final total of all the liabilities and additional responsibilities, net of assets, is \$45,892 billion. Other responsibilities exist that cannot or have not yet been quantified, so this total may be incomplete.

The increase in the present value of Medicare represents a \$9,609 billion increase over fiscal year 2003. For current participants (closed group), the Medicare Prescription Drug Plan (Part D) added \$6,306 billion to the \$9,609 billion increase over fiscal year 2003; this amount is \$8,119 billion when computed for all current and future participants (open group). In the chart below, the comparative value of the estimate for Medicare versus Social Security is shown. In fiscal year 2000, Medicare and Social Security were about even. It is interesting to note that, by 2004, Medicare has grown to a level about twice the level of Social Security.

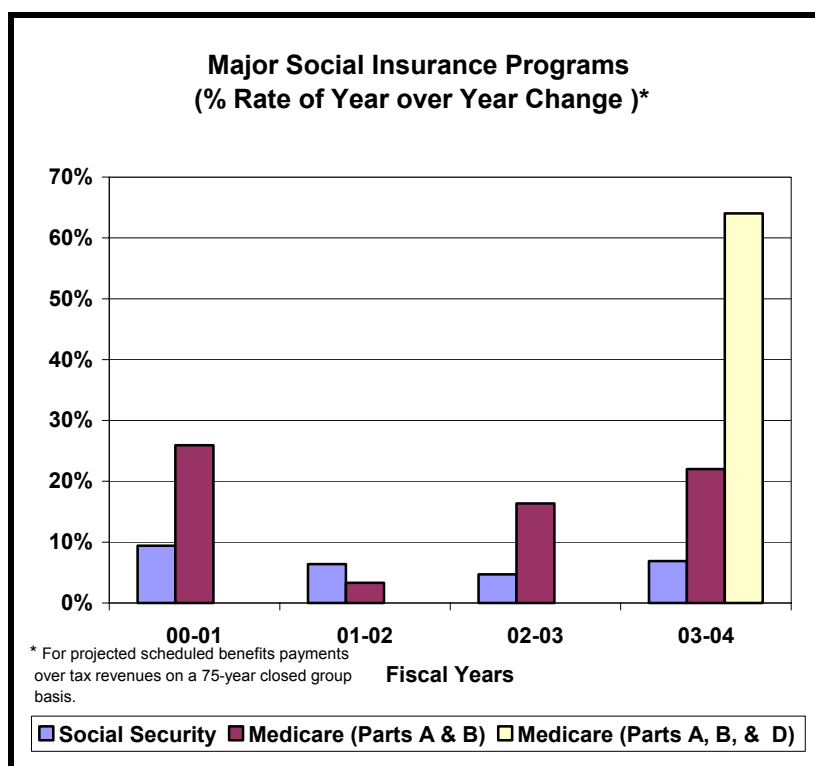


### Comparison of the Growth in Social Security to the Growth in Medicare

Currently, Social Security and Medicare are the principal additional responsibilities and represent more than a third of all Federal spending. Social Security tax revenue, excluding interest, continues to exceed benefits and is expected to do so until 2018. However, Social Security revenue, including interest, is projected to exceed benefits until 2028. Thereafter, scheduled benefit payments are expected to exceed tax revenues and the gap between these revenues and benefits payments will continue to widen. The 2004 Social Security Trustees Report projects that the Social Security trust funds are projected to remain solvent until 2042. Current Social Security law does not provide for full benefit payments after the trust funds are exhausted. The 2004 Medicare Trustees Report projects that Medicare's Part A trust fund will remain solvent until 2019. Moreover, under present law, general fund transfers to Parts B and D's trust fund will occur indefinitely and continue growing with the growing cost of health care.

### Impact of the Medicare Prescription Drug Plan

Medicare's growth has exceeded Social Security's and is projected to continue doing so. According to the chart below, the estimated Social Security cost has been growing at a steady pace of less than 10 percent in all of the last 4 years and less than 7 percent in the last 3 years. On the other hand, projected Medicare responsibilities have been growing at a much faster pace. Parts A and B have increased by over 15 percent in 3 of the last 4 years and by over 60 percent in 2004 with the addition of Part D.



## Featured Balance Sheet Item

This new section has been added to the MD&A for the first time this year to feature one of the many balance sheet items the U.S. Government owns or is responsible for. This year's featured item is environmental and disposal liabilities.

### Environmental and Disposal Liabilities

What are the balance sheet's environmental and disposal liabilities? What agencies are responsible for them? They are amounts of what it would probably cost to remove, contain, or dispose of (i.e., clean up) hazardous waste and environmental contamination caused by Federal operations. Hazardous waste can be a solid, liquid, or gas that can be potentially harmful to human health or the environment. Environmental contamination is caused by the production, storage, and use of radioactive materials and hazardous chemicals.

The Department of Energy (Energy) and DOD are chiefly responsible for environmental and disposal liabilities. For fiscal year 2004, total environmental and disposal liabilities were \$249.2 billion. Energy and DOD reported 99 percent of this amount or \$181.7 billion and \$64.3 billion, respectively. The Government's total amount of environmental and disposal liabilities for fiscal year 2004 declined slightly by \$.7 billion from fiscal year 2003's \$249.9 billion.

Energy has estimated environmental and disposal liabilities on its balance sheet because it is responsible for managing the legacy of contamination from the nuclear weapons complex. The nuclear weapons complex included nuclear reactors, chemical processing buildings, metal machining plants, laboratories, and maintenance facilities. It was developed by the United States during World War II and the Cold War to research, produce, and test nuclear weapons. At all the sites where these activities took place, some environmental contamination occurred.

DOD's environmental and disposal liabilities are based on its responsibility to clean up contamination resulting from past waste disposal practices, leaks, spills, and other past activity, that has created a public health or environmental risk. Some of these responsibilities include the costs of restoring active, realigned, and closed installations, as well as other areas formerly used as defense sites. These costs also include DOD's safe and economical disposal of the U.S. stockpile of lethal and incapacitating chemical warfare agents and munitions.

Finally, DOD's environmental and disposal liabilities are also based on its responsibility to clean up nuclear powered aircraft carriers, submarines, and other nuclear ships. Read Note 12 to find out more about the U.S. Government's environmental and disposal liabilities.

## Federal Debt and Federal Budget

Currently, the largest liability for the Federal Government is the Federal debt held by the public and accrued interest, which was \$4,329.4 billion at the end of 2004. This was an increase of \$384.5 billion over the 2003 debt of \$3,944.9 billion. There are two kinds of Federal debt: debt held by the public and the debt the Government owes to itself.

### Debt Held by the Public

The first kind of Federal debt is debt held by (or owed to) the public. It includes all Treasury securities (bills, notes, bonds, and other securities) held by individuals, corporations, Federal Reserve banks, foreign governments, and other entities outside the U.S. Government. This debt is included as a liability on the balance sheet.

### Debt the Government Owes to Itself

The second kind is debt the Government owes to itself (intra-governmental debt), primarily in the form of special nonmarketable securities held by various parts of the Government. The laws establishing Government trust funds generally require the excess receipts of the trust funds to be invested in these special securities. This debt is not included on the balance sheet since these payments are claims of one part of the Government against another and are eliminated for consolidation purposes.

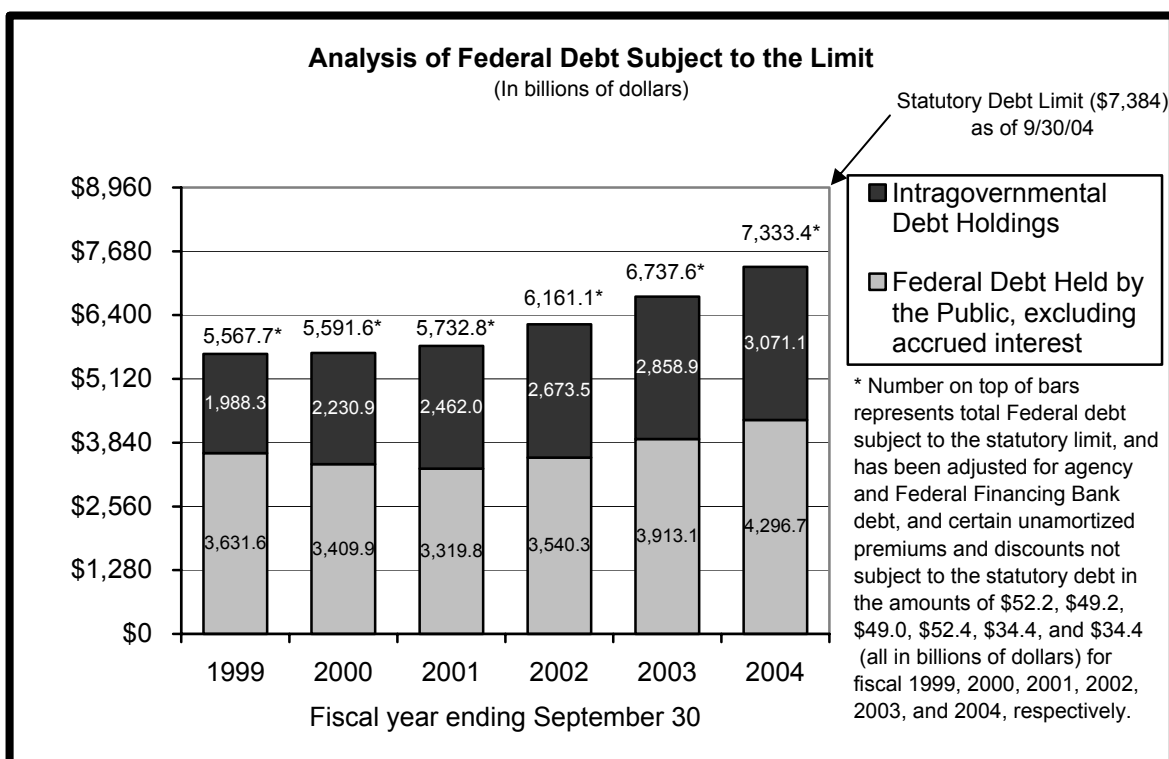
### Statutory Debt Ceiling (Limit)

Both kinds of debt are included in the total debt subject to the limit set by the Congress. The Congress has traditionally established limits on the amount of Treasury securities that can be outstanding. This limit is known as the debt ceiling.

At the end of fiscal year 2004, the outstanding debt subject to the limit approached the statutory limit of \$7,384 billion. Subsequent to the end of the fiscal year, on October 14, 2004, the outstanding debt reached the limit. When the debt reaches the statutory limit, Treasury uses numerous statutory tools that allow the Government to manage without increasing the outstanding debt subject to the statutory limit and to continue operations for short periods of time. In October 2004, Treasury notified Congress, as required, of its intent to use these tools.

The most significant of these tools includes not fully reinvesting the overnight investments of the Government Securities Investment Fund (or "G-Fund"). On the day that new legislation is enacted to establish a new statutory limit, Treasury fully reinvests all principal to the G-Fund. Lost interest is restored to the G-Fund on the following business day. On November 19, 2004, the President signed legislation raising the statutory debt limit by \$800 billion to \$8,184 billion (P.L. 108-415).

The following chart shows the amounts of debt held by the public and intra-governmental debt from 1999 through 2004.



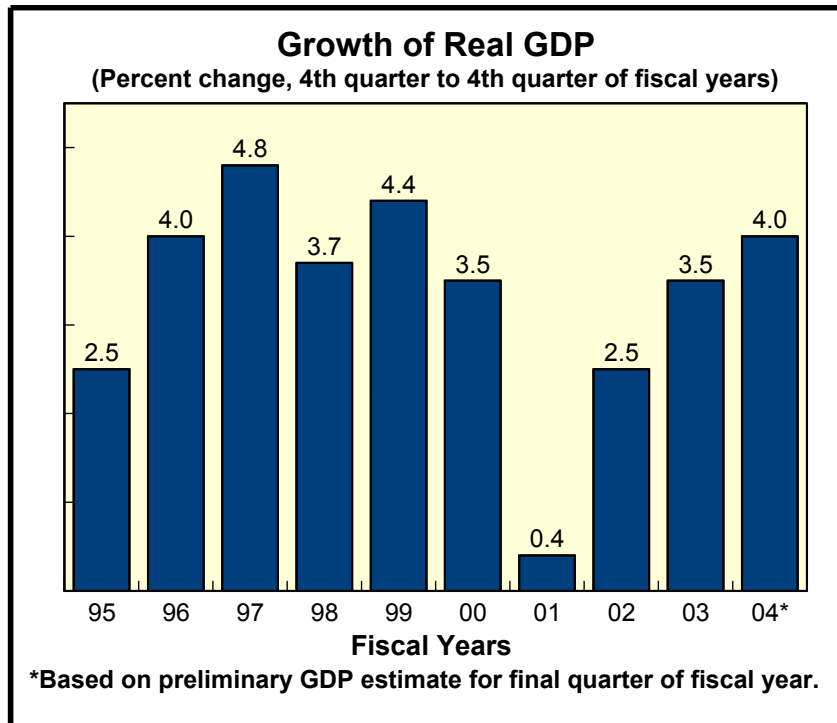
## Economic and Budgetary Results

The economy strengthened in fiscal year 2004, with real GDP growing at a faster pace than in the prior fiscal year and employment posting a large increase after declining in each of the previous 3 fiscal years. Rising employment and income contributed to an increase in budget receipts in fiscal year 2004, the first gain in 4 years. Outlays rose more than receipts, and the Federal budget deficit widened in fiscal year 2004.

### The Economy in Fiscal Year 2004

After rising 3.5 percent across the four quarters of fiscal year 2003, real GDP increased 4 percent during fiscal year 2004. Large gains in residential and business fixed investment contributed to the acceleration. Real residential investment rose 8.1 percent over the year, extending the strong expansion in the housing market that has been underway for roughly the past 10 years. Real business fixed investment (in capital equipment and software and in structures) grew 10.1 percent over the four quarters of fiscal year 2004, faster than the 5.8 percent increase during fiscal year 2003. Investment in equipment and software was up 12.8 percent in fiscal year 2004 while investment in structures turned up by 1.5 percent after declining in each of the previous 3 fiscal years. Strong profits growth and strength in aggregate demand have been the key drivers of the ongoing rise in business investment, supported as well by the tax incentives provided in the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Higher profits and cashflow allowed businesses to increase hiring. Monthly job growth accelerated sharply midway through fiscal year 2004, averaging 84,000 per month from October 2003 through February 2004, then jumping to a monthly average of 200,000 from March through September. The economy added more than 2 million new payroll jobs during fiscal year 2004 (after allowing for the Bureau of Labor Statistics' estimate of the 2004 benchmark revision), and the unemployment rate fell to an average of 5.6 percent during the fiscal year compared to 6 percent in fiscal year 2003. Inflation was generally subdued during the 2004 fiscal year with the exception of energy prices, which continued to rise. Overall consumer prices rose 2.5 percent over the 12 months of the fiscal year while core consumer prices (excluding food and energy) increased just 2 percent.

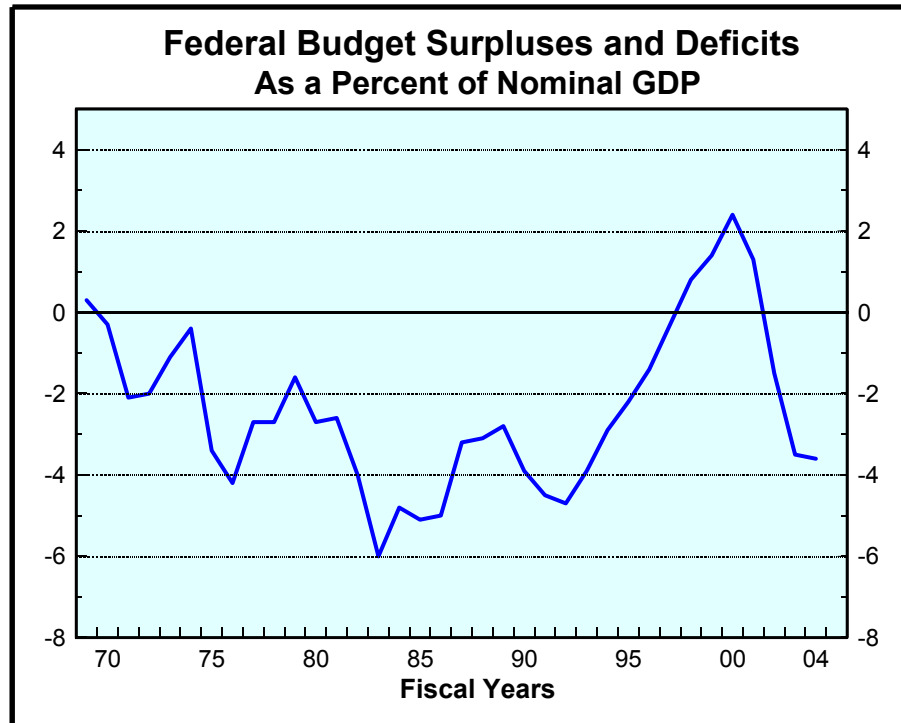


## Budget Results

The Federal budget deficit in fiscal year 2004 was \$412.3 billion, an increase of \$35.2 billion from the \$374.8 billion deficit in fiscal year 2003. The final figure came in less than had been projected in July's Mid-Session Review, which anticipated a deficit of \$444.7 billion for the fiscal year. Though the \$412.3 billion deficit is the highest in dollar terms, the 3.6 percent share of nominal GDP that it represents is well below the fiscal year 1983 peak of 6 percent and lower than the shares of the mid-1980s and early 1990s.

Receipts in fiscal year 2004 increased for the first time in 4 years, primarily due to gains in total taxes and in social insurance and retirement receipts. Receipts rose \$97.7 billion (or 5.5 percent) to \$1,879.8 billion. That was the highest level since fiscal year 2001. Outlays rose \$135.2 billion in the latest fiscal year (or 6.2 percent), and the \$2,292.1 billion level of outlays represented a 19.8 percent share of GDP.

Debt held by the public, excluding accrued interest, increased by \$379.7 billion in fiscal year 2004 to a level of \$4,292.9 billion by yearend. Though an all-time high in dollar terms, the debt level represented a relatively modest 37.2 percent of nominal GDP compared to the average 45.3 percent share that prevailed from the late 1980s through most of the 1990s.



## U.S. Government Structure & Performance

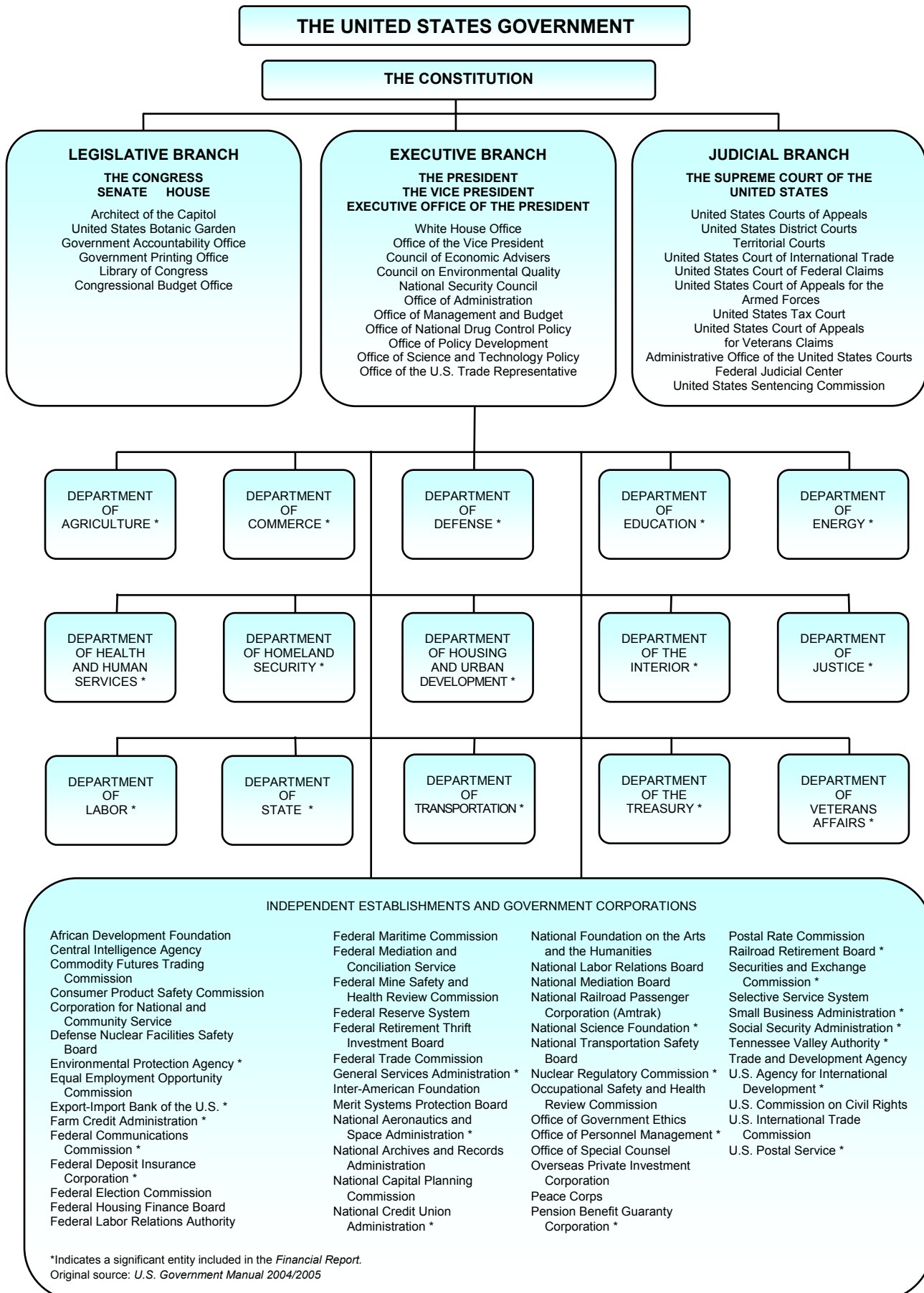
### Mission & Organization

Today, the U.S. Government's most visible mission of managing the security of the Nation, homeland, and economy is still derived from its original mission in the Constitution: "...to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote general welfare and secure the blessings of liberty to ourselves and our posterity." Since the original mission's inception, other missions have developed as the Congress authorized the creation of other agencies to carry out various objectives established by law. Some of these objectives are to promote health care, foster income security, boost agricultural productivity, provide benefits and services to veterans, facilitate commerce, support housing, support the transportation system, protect the environment, contribute to the security over energy resources, and assist the States in providing education.

### U.S. Government's Organization

The fundamental organization of the U.S. Government is established by the Constitution. Article I vested legislative powers in a Congress consisting of a Senate and a House of Representatives; Article II vested executive powers in a President and Vice President; and Article III vested judicial power in a Supreme Court and lower courts to be established by the Congress. To get an idea of how the U.S. Government is organized, even though not all-inclusive, a U.S. Government organization chart follows.





The United States is impressive in its position as the leading world power. The following table illustrates several notable items about the United States, as compared with other countries.

Item	United States	Estimate as of	Country Rank	Comments
Land and water area (50 states and the District of Columbia)	9.6 million sq. km	NA	3	About half the size of Russia; slightly larger than China; and about two and a half times the size of Western Europe
Population	293 million	2004 (July)	3	China (1.3B) and India (1.1B) are greater
Gross domestic product (GDP) (basis: purchasing power parity) <sup>1</sup>	\$10.98 trillion	2003	1	China was second with \$6.4 trillion
GDP per capita	\$37,800	2003	2	Luxembourg was first with \$55,100
Military expenditures (as a percentage of GDP)	3.9 percent	2001	30	North Korea was first with 22.9 % (2003)
Internet users	159 million	2002	1	China, Japan, and Germany had 59.1 million, 57.2 million, and 34 million, respectively
Cellular telephones	140.8 million	2002	2	China was first with 206.6 million
<sup>1</sup> Purchasing power parity indicates how many units of currency are needed in one country to buy the same amount of goods and services purchased with one unit of currency in another country. Source: Central Intelligence Agency's <i>The World Factbook 2004</i>				

## Featured Agency: The Department of the Interior

This year is the first time that this section has been added to the MD&A to feature an agency of the U.S. Government and to acquaint the reader with just one of the U.S. Government's many missions.

One of the most fascinating agencies of the Federal Government is the Department of Interior (DOI). What is it, and what does it do? Created by Congress in 1849, DOI is our Nation's primary conservation agency and steward of our natural and cultural resources. It oversees about 507 million acres of U.S. public lands.

Created by Congress in 1849, it served initially as the Nation's custodian. Today, its mission is to protect and provide access to our Nation's natural and cultural heritage and honor the Nation's trust responsibilities to Indian Tribes and its commitments to island communities. DOI fulfills its mission through its eight bureaus.

Interior and Bureau Missions			
<p align="center"><b>U.S. Department of the Interior</b></p> <p align="center">“Protects and manages the Nation’s natural and cultural heritage; provides scientific and other information about those resources; and honors special responsibilities and commitments to American Indians, Alaska Natives, and affiliated island communities.”</p>			
 <p align="center"><b>BUREAU OF INDIAN AFFAIRS</b></p> <p>Enhance the quality of life and to promote economic opportunity in balance with meeting the responsibility to protect and improve the trust resources of American Indians, Indian tribes, and Alaska Natives.</p>	 <p align="center"><b>NATIONAL PARK SERVICE</b></p> <p>Preserve unimpaired the natural and cultural resources and values of the National Park System for the enjoyment, education, and inspiration of this and future generations. The Park Service cooperates with partners to extend the benefits of natural and cultural resource conservation and outdoor recreation throughout this country and the world.</p>	 <p align="center"><b>U.S. FISH AND WILDLIFE SERVICE</b></p> <p>Conserve, protect, and enhance fish and wildlife and their habitats for the continuing benefit of the American people.</p>	 <p align="center"><b>BUREAU OF LAND MANAGEMENT</b></p> <p>Sustain the health, diversity, and productivity of the public lands for the use and enjoyment of present and future generations.</p>
 <p align="center"><b>BUREAU OF RECLAMATION</b></p> <p>Manage, develop, and protect water and related resources in an environmentally and economically sound manner in the interest of the American public.</p>	 <p align="center"><b>U.S. GEOLOGICAL SURVEY</b></p> <p>Provide the Nation with reliable, unbiased information to describe and understand the earth; minimize loss of life and property from natural disasters; manage water, biological, energy and mineral resources; and enhance and protect our quality of life.</p>	 <p align="center"><b>MINERALS MANAGEMENT SERVICES</b></p> <p>Manage the mineral resources on the Outer Continental Shelf in an environmentally sound and safe manner and collect, verify, and distribute mineral revenues from Federal lands and Indian lands in a timely manner.</p>	 <p align="center"><b>OFFICE OF SURFACE MINING</b></p> <p>Ensure that coal mines are operated in a manner that protects citizens and the environment during mining; assure that land is restored to beneficial use following mining; and mitigate the effects of past mining by aggressively pursuing reclamation of abandoned mine lands.</p>
Source: Department of the Interior’s FY 2003 <i>Annual Report on Performance and Accountability</i> , p. 6.			

## Significant Performance Accomplishments

### The President's Management Agenda: Managing for Results

Fiscal responsibility requires the sound stewardship of taxpayer money. This means that once the Congress and the President decide on overall spending levels, taxpayer dollars should be managed to maximize results. The PMA is creating a results-oriented Government where each agency and program is managed professionally and efficiently and achieves the results expected by the Congress and the American people.

The PMA, launched in August 2001 with the broad goal of making the Government more results-oriented, focuses on achievement, efficiency, and accountability. It emphasizes improving how the Government operates by setting clear goals and action plans, and then following through on those plans. Agencies continue to manage for and achieve better results.

#### Strategic Management of Human Capital

The Strategic Management of Human Capital Initiative focuses on helping the Government maximize the value of its most important resource, its workforce. Agencies are now establishing and implementing personnel management practices to better achieve their missions.

Agencies are making sure their employees understand what is expected of them and how their work contributes to the achievement of the agency's mission. Appraisal systems are making clear how employees will be evaluated and distinguishing between high and low performers. Proper implementation of strong performance appraisal systems will provide the necessary foundation for establishing pay for performance systems where an individual's pay is more directly linked to his or her performance and achievements instead of longevity.

To meet current and future leadership needs, agencies are making certain they have sufficient talent pools. Over the past year, several agencies have established programs to strengthen their management and Senior Executive Service leadership ranks. These programs aim not only to ensure that potential future managers are waiting in the wings, but that those individuals have the proper skills to work in today's changing work environment.

#### Competitive Sourcing

The Government is conducting public-private competitions to determine whether it is more efficient to have commercial work performed by Federal employees or the private sector. Agencies have worked to establish infrastructures to apply competition in the most strategic manner possible, such as by reorganizing inefficient in-house operations, developing competition plans that group related activities to generate private sector interest, and aligning competitive sourcing and human capital efforts to close competency and skill gaps. The PMA agencies project that the more than 660 assessments they completed in fiscal year 2003 will yield \$1.1 billion in savings over the next 3 to 5 years. This translates to annualized savings of roughly \$12,000—or roughly 15 percent—for every position studied, regardless of whether the work is being performed by the Government or by the private sector. With experience, the return on investment will only get better.

#### Improved Financial Performance

The ultimate goal of the Improved Financial Performance initiative of the PMA is that managers have access to timely and accurate financial information for decision-making. Audited financial statements provide assurance that agencies are accounting for the taxpayers' money in an accurate manner. This year 22 of 24 major Federal agencies issued their Performance and Accountability Reports, including audited financial statements, within 45 days from the end of the fiscal year. This marks a significant milestone in federal financial management since only a few years ago agencies took up to five months to produce similar information. Meeting this goal required agencies to implement new financial management disciplines and processes, which are the foundation for more reliable information to support day-to-day management.

By establishing greater financial discipline and better control, agencies are producing financial reports in a shorter period of time and with greater confidence in data accuracy. Since the beginning of 2003, the number of auditor-reported material weaknesses government-wide has decreased by 12 percent, and, fewer material weaknesses translate to greater confidence that financial information is correct. As agencies improve their financial

business practices and install new financial management systems and reporting tools, data timeliness and accuracy will continue to improve.

There has also been ongoing improvement in the number of agencies demonstrating their ability to use timely and accurate financial information to make decisions about program management. During this past year, two additional agencies demonstrated this capability, increasing the total number of agencies to six. By using timely financial information for decision making and program management, agencies are taking steps toward improving their financial performance and overall management of Federal dollars.

### **Expanded Electronic Government**

The Expanded Electronic Government initiative focuses on two key areas—strengthening agencies’ management of their information technology (IT) resources and using the Internet to simplify and enhance service delivery. The Government must capitalize on its more than \$60 billion annual investment in IT.

Most agencies have made improvements in IT management over the last year. Over 97 percent of major systems include measurable program objectives in their justifications. Sixty-one percent of IT systems have been certified and accredited, versus 47 percent for fiscal year 2002. Sixty-two percent are at various stages of developing modernization blueprints, which are an integral part of ensuring that their IT investments support overall agency goals and are not redundant of Governmentwide IT investments. These improvements will be a central ingredient in developing a more thoughtful, productive approach to IT investment across agencies.

Specific improvements in service delivery are being achieved through the E-Gov Initiatives. For instance, Grants.gov makes it easier for potential recipients to obtain information about Federal grants by creating a single, online site for all Federal grants. Because of e-Travel, the new web-based, consolidated Federal travel management system, the Government expects to spend nearly \$300 million less over the next 10 years on travel-related activities.

The Government is investing significant resources in IT to assist it in achieving its mission and better serving the American taxpayer. Agencies are making improvements towards ensuring that these investments are well managed, more secure, and providing services to the American people more efficiently and effectively.

### **Budget and Performance Integration**

Many agencies are now using meaningful program performance information to inform their budget and management decisions. In particular, a third of the Government’s major agencies meet regularly to use performance information to make program management decisions. Agencies are using the information gleaned from the PART to identify programs’ strengths and weaknesses and take appropriate action. The Program Assessment Rating Tool (PART) assessments have helped focus agency efforts to improve program results. Agencies have now assessed the performance of approximately 400 Federal programs, representing more than 1 trillion dollars in Federal spending. Summaries of PART findings for each program assessed, as well as the detailed PART analyses for those programs, can be found at the OMB website.

The Administration is also using the PART to compare the performance and management of similar programs across Government so that lessons about how to improve program performance can be shared among those programs. These analyses will tell us what steps we need to take to improve program performance for similar programs across Government.

The PART is a vehicle for improving program performance. As more program assessments are conducted, of the Administration will have better program performance information to use when making budget and management decisions. Agencies will be better able to describe to the taxpayer what his or her funding is purchasing and will be managing so that each year improvements in efficiency and service delivery can be documented.

### **Eliminating Improper Payments**

Agencies are also taking steps to measure their improper payments, which include but are not limited to, payments made in an incorrect amount, to an ineligible recipient, for a service not received, or for improper use of Federal funds. Eliminating improper payments has been added to the PMA as a new program initiative to highlight its importance. This program initiative affects the 15 Executive Branch agencies with the most high risk programs.

With the enactment of the Improper Payments Information Act (IPIA), agencies are now developing and implementing improper payment plans that will lead to the review of every dollar the Government spends. Fiscal year 2004 begins the first year of reporting under IPIA.

### **Asset Management**

In conjunction with Executive Order (EO) 13327, “Federal Real Property Asset Management,” a new program initiative under the PMA was created in the 3<sup>rd</sup> quarter of fiscal year 2004. The Federal Real Property Asset Management initiative, which applies to the largest landholding agencies, is aimed at improving the management of

real property assets on a Governmentwide level by holding agencies accountable for implementing a more effective and economical approach to real property management.

Pursuant to the EO, all major agencies designated a Senior Real Property Officer to be held accountable for the effective management of agency real properties. An interagency Federal Real Property Council has also been created to develop guidance, serve as a clearing house for best practices, and facilitate the efforts of the agency Senior Real Property Officers. Agencies must develop a complete and accurate inventory, develop and implement asset management plans, develop and monitor real property performance measures, and dispose of properties that are no longer needed.

## Executive Branch Management Scorecard

The PMA is used to measure agencies' progress and overall achievement in meeting the overall goals of the PMA. These overall goals, known as standards for success, are specified for each initiative and available at [www.whitehouse.gov/results/agenda/standards.pdf](http://www.whitehouse.gov/results/agenda/standards.pdf). A copy of the Scorecard follows.

Explanation of Status Scores	
<b>Green</b>	Agency meets all of the standards for success.
<b>Yellow</b>	Agency has achieved intermediate levels of performance in all the criteria.
<b>Red</b>	Agency has any of a number of serious flaws.
Explanation of Progress Scores	
<b>Green</b>	Implementation is proceeding according to plans.
<b>Yellow</b>	Slippage in implementation schedule, quality of deliverables, or other issues requiring adjustments by agency in order to achieve initiative on a timely basis.
<b>Red</b>	Initiative in serious jeopardy. Unlikely to realize objectives without significant management intervention.

Executive Branch Management Scorecard										
	Current Status as of September 30, 2004					Progress in Implementing the President's Management Agenda				
	Human Capital	Competi- tive Sourcing	Financial Perf.	E-Gov	Budget/ Perf. Integra- tion	Human Capital	Competi- tive Sourcing	Financial Perf.	E-Gov	Budget/ Perf. Integra- tion
AGRICULTURE	Y	Y	R	Y	Y	G	Y	G	G	G
COMMERCE	Y	Y	Y↑	Y	Y	G	Y	G	G	G
DEFENSE	Y	G	R	R	Y	G	Y	Y	G	G
EDUCATION	Y	Y	G	Y	Y	G	G	G	G	G
ENERGY	G	G	G	Y	G↑	G	G	G	G	G
EPA	Y	Y	G	G	Y	G	G	G	G	G
HHS	G↑	G	R	Y↑	Y	G	G	Y	G	G
HOMELAND	R	Y	R	R	Y↑	G	G	G	Y	G
HUD	Y	R	R	R	R	G	Y	Y	G	G
INTERIOR	Y	Y	R	Y	R	G	Y	G	G	G
JUSTICE	Y↑	Y	R	Y	Y↑	G	G	G	G	G
LABOR	G	Y	G↑	G↑	G	G	G	G	G	G
STATE	G	R	Y	G↑	G↑	G	G	G	G	G
DOT	G	G	R	G	G	G	G	G	G	G
TREASURY	Y↑	Y	R	R	Y↑	G	Y	Y	G	G
VA	Y	R	R	Y	Y	G	R	R	Y	G
USAID	R	R	R	Y	Y	G	Y	G	G	G
CORPS OF ENGINEERS	Y	R	R	R	R	G	G	Y	G	Y
GSA	Y	G↑	R	Y↑	Y↑	G	G	G	G	G
NASA	G	Y	R	G↑	G	G	G	R	G	G
NSF	Y	R	G	G	Y	G	R	G	G	G
OMB	Y	R	R	R	R	G	R	G	G	R
OPM	G	G	Y	G	Y	G	Y	G	G	Y
SBA	Y	Y	R	G	G	G	Y	G	G	G
SMITHSONIAN	R	R	R	R	R	G	R	Y	Y	Y
SSA	G	Y	G	Y	G	G	G	G	Y	G

*Legend:* **R** = Red    **Y** = Yellow    **G** = Green  
 ↑↓ Arrows indicate change in status since evaluation on June 30, 2004.

## Systems, Controls, and Legal Compliance

### Systems

The Federal Government continues to face challenges in achieving greater efficiency and effectiveness of its financial management systems. The most significant steps toward overcoming these challenges have been the agreement on core system requirements and the development of a software certification process based on those requirements. Most major agencies have purchased and some have completed the implementation of certified commercial-off-the-shelf financial management systems. Despite built-in best practices and standard business processes, many agencies have struggled with the challenges inherent to the implementation of these complex systems.

To address these challenges and to eliminate redundant investments, OMB launched the *Financial Management Line of Business (FM-LOB)* as one of the five LOB initiatives. The FM-LOB business case will reduce the cost of agency financial management systems by migrating them to Centers of Excellence (COE). The COEs may be operated by public agencies, private firms, or public/private partnerships. Some agencies will be selected in fiscal year 2005 to operate COEs. Agencies will schedule their migrations consistent with the economics of their systems' life cycles. The FM-LOB will help agencies increase their efficiency and improve business performance while ensuring integrity in accountability, financial controls, and mission effectiveness.

### Controls

#### Internal Control

Effective internal control is a key factor in producing reliable financial information. Ensuring the proper stewardship of federal resources is a fundamental responsibility of agency managers and staff. Effective internal control helps ensure that programs are managed with integrity and resources are used efficiently and effectively.

The recent emphasis on internal control and reliable financial reporting contained in the Sarbanes-Oxley Act (SOX) of 2002 for publicly-traded companies has served as an impetus for a re-examination of internal control requirements within the Federal Government.

During fiscal year 2004, the Office of Management and Budget took action to convene representatives from the Chief Financial Officers Council (CFOC) and the President's Council on Integrity and Efficiency (PCIE) to review the SOX requirements and determine how those requirements apply to the Federal government. The joint committee found that within the current Federal environment, agencies are subject to a variety of existing legislative and regulatory requirements intended to promote and support effective internal control. At the center of these existing requirements is the Federal Managers' Financial Integrity Act of 1982 (FMFIA) and OMB Circular No. A-123, Management Accountability and Control, which requires agencies to annually evaluate and report on the effectiveness of their internal control and report material weaknesses to the President and the Congress.

In addition, FMFIA also requires an annual statement on whether the agency's financial management systems conform to Governmentwide requirements. The Federal financial management requirements are mandated by the Federal Financial Management Improvement Act of 1996 (FFMIA) and OMB Circular No. A-127, Financial Management Systems. FFMIA requires agency management and financial statement auditors to determine whether financial management systems meet systems requirements, comply with the U.S. Standard General Ledger at the transaction level, and adhere to the standards promulgated by the Federal Accounting Standards Advisory Board (FASAB).

The joint CFOC/PCIE committee recommended that OMB strengthen its existing guidance for assessing the effectiveness of internal control. Amendments to OMB guidance were developed by the joint committee to adopt the standards prescribed in GAO's Standards for Internal Control in the Federal Government (November 1999), which are consistent with the Integrated Framework of Internal Control issued by the Committee of Sponsoring Organizations of the Treadway Commission, and to require a more comprehensive and coordinated approach to assessing the effectiveness of internal control over financial reporting. OMB plans to release amendments to Circular A-123 by the end of the 2004 calendar year to be effective for fiscal year 2006.



## Legal Compliance

Federal agencies are required to comply with a wide range of laws and regulations, including appropriations, employment, health and safety, and others. Responsibility for compliance primarily rests with agency management. Compliance is addressed as part of agency financial statement audits. Agency auditors test for compliance with selected laws and regulations related to financial reporting. As a result of their testing, auditors found no instances of material noncompliance that affected the Governmentwide financial statements. There were, however, instances that were material to an individual agency, and these were reported in the individual agencies' financial statement audit reports.

## Basis of Accounting and Reporting Entity

### Accounting Standards

The accompanying financial statements were prepared based on U.S. GAAP standards developed by FASAB. GAAP for the Federal Government is tailored to the U.S. Government's unique characteristics and special needs. For example, the Stewardship Information section of this report contains important information about diverse subjects such as land set aside for the use and enjoyment of present and future generations, heritage assets, and social insurance programs such as Social Security.

### Accrual Basis

GAAP requires that these financial statements be prepared using the accrual basis of accounting, but permits the use of modified cash accounting for taxes and duties. Under the accrual basis, transactions are reported when the events creating the transactions occur, rather than when cash is received or paid (cash basis). Therefore, expenses are recorded when incurred, exchange revenue is recorded when earned, and taxes and duties (the majority of nonexchange revenue) are recorded on a modified cash basis of accounting (generally when received). In contrast, Federal budgetary reporting is generally on the cash and obligation basis in accordance with accepted budget concepts.

The most significant difference between cash and accrual bases involves the timing of recognition and measurement of revenues and costs. For example, GAAP requires recognition of liabilities for costs related to environmental cleanup when the events requiring such costs occur and, among other things, the Government has acknowledged responsibility for the event. By contrast, current budget concepts recognize such costs later, at the time payment is made for the cleanup. Additionally, GAAP requires the recognition of depreciation expenses on fixed assets, a liability for accrued leave, and the total actuarial liabilities for pensions, retired pay, and post-retirement health benefits. These differences are reflected in the Reconciliations of Net Operating Cost and Unified Budget Deficit that is found in the Financial Statements section of this *Financial Report*.

### Coverage

These financial statements cover the three branches of the U.S. Federal Government. A list of the significant entities included in these financial statements is in the Appendix. Information from the judicial branch is limited to budgetary activity because these entities are not required by law to submit comprehensive financial statement information to the Treasury. The Federal Reserve System is excluded because it is an independent entity within the Government, having both public purposes and private aspects. The Federal Retirement Thrift Investment Board is excluded because it charges all of its administrative expenses to the Thrift Savings Fund, which is fiduciary in nature. Therefore, it has no financial activity that would affect the Government's results. Moreover, Government-

sponsored but privately-owned enterprises (e.g., the Federal Home Loan Banks, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation) are also excluded.

## Additional Information

The Appendix contains a list of the significant Government entities included in the *Financial Report's* financial statements, along with their respective web sites. Details about the information contained in the *Financial Report* can be found in the financial statements of these entities in their individual Performance and Accountability Reports at their corresponding web sites. In addition, related U.S. Government publications such as the *Budget of the United States Government*, the *Treasury Bulletin*, the *Monthly Treasury Statement of Receipts and Outlays of the United States Government*, the *Monthly Statement of the Public Debt of the United States*, the *Economic Report of the President*, and the Trustees' Reports for the Social Security and Medicare programs may be of interest and accessed from the respective White House (OMB and Council of Economic Advisers), Treasury, SSA, and HHS web sites listed in the Appendix.

## History of the Report

### Financial Reports of the United States Government

The purpose of this report is to provide a longer term accrual perspective to the financial results of the Government. In this way those costs that may take years to be realized through payments, but committed to in the current period, can be recorded and become part of the discussion of the financial well being of the Nation.

The Government Management Reform Act of 1994 (GMRA) required audited financial statements from the 24 CFO Act Federal departments and agencies beginning for fiscal year 1996. GMRA also required the U.S. Government to submit consolidated financial statements audited by GAO beginning for fiscal year 1997's *Financial Report of the United States Government*.

The Treasury Department has prepared a prototype report for many years beginning in the mid-seventies. The earliest reports were accrual-based and included a balance sheet and statement of operations and were not audited, though Treasury hired private sector firms to conduct independent reviews of source data and collection procedures. (For a more complete discussion visit [http://www.treas.gov/offices/economic-policy/financial\\_report\\_hist.pdf](http://www.treas.gov/offices/economic-policy/financial_report_hist.pdf).)

In 1990, a Memorandum of Understanding between Treasury, OMB, and GAO created FASAB to develop formal Federal accounting standards and concepts. And in 1999, the American Institute of Certified Public Accountants recognized FASAB as the promulgator of GAAP for the Federal Government. FASAB continually reviews its reporting standards to enhance the usefulness of the Government's financial statements to all users.

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